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Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting off More than They Can Chew

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Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting off More than They Can Chew

Abstract

A pitched battle is currently being waged for control of the American banking industry. For over a hundred years, the federal and state governments have maintained a complex, but relatively stable truce in their contest for power. At the beginning of our republic, state governments were the primary charterers and regulators of banks. In the wake of the Civil War, the National Bank Act created parity between federal and state banks, cementing the notion of a dual banking system that endured through the twentieth century. But in the past five years, the federal government has increasingly used its powers under the Supremacy Clause of the U.S. Constitution to grab new authority for federal banking regulators and for federally chartered depository institutions. A series of controversial federal regulations have preempted the application of state consumer protection laws directed at prevention of predatory lending by national banks and thrifts. The preempted state laws address a recent rash of fraudulent, deceptive, and unconscionable lending that is having a corrosive effect on minority communities, senior citizens, and the entire lower middle class. In a related move, federal banking regulators have also recently preempted the application of state law to independent contractors of national banks and thrifts.

This essay explains the potentially far reaching impact of federal preemption of state regulation of independent contractors. If these determinations are upheld, thousands of businesses, including insurance agents, mortgage brokers, and automobile dealers, will be placed beyond state oversight - provided that they have agency relationships with a national bank or thrift. Moreover, this essay uses economic agency cost theory to explore the potential for mischief posed by placing bank and thrift agents beyond the reach of state government. In particular, this Article argues that bank and thrift agents, by their nature, have lower incentives to forego predatory lending than the depository institutions themselves. Given the limited resources of federal banking regulators and their primary focus on safety and soundness, the Article concludes that preemption of state regulation of bank and thrift agents is currently inadvisable.

Keywords

Predatory lending, Loan, Credit, Debt, Bankruptcy, Truth in Lending, Fair Debt Collection Practices, Equal Credit Opportunity, Fraud, Deceptive trade, Comptroller, Thrift, Bank, Preemption, National Bank Act

PREEMPTION, AGENCY COST THEORY, AND PREDATORY LENDING BY BANKING AGENTS: ARE FEDERAL REGULATORS BITING OFF MORE THAN THEY CAN CHEW?

CHRISTOPHER L. PETERSON^{*}

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INTRODUCTION

A pitched battle is currently being waged for control of the American banking industry. For over one hundred years, the federal government and many state governments have maintained a complex but relatively stable truce in their contest for power. At the beginning of our republic, state governments were the primary charterers and regulators of banks. In the wake of the Civil War, the National Bank

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Act¹ created parity between federal and state banks, cementing the notion of a “dual banking system” that endured through the twentieth century. But in the past five years, the federal government has become esurient, using its powers under the Supremacy Clause² of the U.S. Constitution to cut a new and wider footprint of authority for federal banking regulators and for banks that rally to their banner. A series of controversial federal regulations have preempted the application of state consumer protection laws directed at the prevention of “predatory lending” by national banks and thrifts. These regulations are controversial, not merely because the recent rash of fraudulent, deceptive, and unconscionable lending has had a corrosive effect on minority communities, senior citizens, and the entire lower middle class. Rather, their controversy lies in the fact that democratically-elected state representatives all across the country responded to their constituents’ demands by adopting such legislation, and no federal statute had ever explicitly authorized the unelected beltway banking custodians to dismiss these state consumer protection laws.³ In fairness, federal regulators have levied persuasive

1. 12 U.S.C. § 38 (1864).

2. U.S. CONST. art. VI, § 2.

3. In the case of home mortgage loans, approximately forty states, counties, and municipalities have adopted predatory lending laws attempting to protect homeowners from predatory mortgage brokers and lenders. State laws include: Arkansas Home Loan Protection Act, ARK. CODE ANN. § 25-53-101 (2006); CAL. FIN. CODE §§ 4970-4979.7 (West 2003); Consumer Equity Protection Act, COLO. REV. STAT. ANN. § 5-3.5-201 (West 2006); Connecticut Abusive Home Loan Lending Practices Act, CONN. GEN. STAT. §§ 36a-746-747, 754 (2006); Home Loan Protection Act, D.C. CODE § 26.1151.01 (2006); Fair Lending Act, FLA. STAT. ANN. §§ 494.0079-.00797 (West 2006); Georgia Fair Lending Act, GA. CODE ANN. § 7-6A-1 (2006) (as amended); IDAHO CODE ANN. § 26-3103 (2006); High Risk Home Loan Act 137 ILL. COMP. STAT. § 1-137/175 (2006); Indiana Home Loan Practices Act, IND. CODE § 24-9-4-1 (2006); Consumer Credit Code, KAN. STAT. ANN. § 16a-1-101 (2006); High Cost Home Loan Act, KY. REV. STAT. ANN. § 360.100 (West 2006); Truth in Lending, ME. REV. STAT. ANN. tit. 9-A, § 8-101 (2006); Massachusetts Predatory Home Loan Practices Act, MASS. GEN. LAWS ch. 183C, § 1 (2006); Consumer Mortgage Protection Act, MICH. COMP. LAWS §§ 445.1631-1645 (2006); Nevada Assembly Bill No. 284, NEV. REV. STAT. § 598D.010 (2006); New Jersey Home Ownership Security Act of 2002, N.J. STAT. ANN. § 46:10B-22 (West 2006); Home Loan Protection Act, N.M. STAT. ANN. §§ 58-21A-1 (West 2006); N.Y. BANKING LAW § 6-L (Consol. 2006); Restrictions and Limitations on High Cost Home Loans, N.C. GEN. STAT. § 24-1.1E (2006); Consumer Protection Predatory Lending Act, OHIO REV. CODE ANN. §§ 1349.25-1349.39 (West 2006); Consumer Credit Code, OKLA. STAT. tit. 14A, § 1-101 (2005); Mortgage Bankers and Brokers and Consumer Equity Protection Act, 63 PA. CONS. STAT. §§ 456.501-456.524 (2006); South Carolina High Cost and Consumer Home Loans Act, S.C. CODE ANN. § 37-23-10 (2005); TEX. FIN. CODE ANN. § 343.001 (Vernon 2001); West Virginia Residential Mortgage Lender, Broker, and Servicer Act, W. VA. CODE ANN. § 31-17-1 (West 2006); WIS. STAT. §§ 428.101-428.211 (2004). Local ordinances include: CHI., ILL., MUNICIPAL CODE OF CHICAGO, PREDATORY LENDING ORDINANCE §§ 2-32-4545, 2-92-325, 4-4-155, 8-4-325 So2000-2145 of 2000 (2000); PROTECTION FROM PREDATORY LENDING AND MORTGAGE FORECLOSURE IMPROVEMENTS ACT OF 2002, D.C. Law 14-132; D.C. CODE § 26-1151.01 (2001); PHILADELPHIA, PA., PROHIBITION AGAINST

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arguments justifying their decisions as necessary in an increasingly national financial services marketplace. In their view, as technology shrinks our world, the notion of fifty different banking jurisdictions is quaint, inefficient, and perhaps even silly. Would it not save everyone a lot of time and trouble if we had only one set of laws to govern the banking industry?

In a recent article, I observed that the political economy driving federal preemption of state banking regulation has a tendency to magnify the effect of preemptive action.⁴ Because federal banks, state banks, thrifts, credit unions, and non-depository lenders all act in the same zero-sum competitive environment, political shelter for one type of institution is a direct threat to every other type of institution.⁵ When the regulatory patrons of one type of institution act to relax the regulatory constraints of their members, rival patrons must respond or risk losing their regulatory turf as the institutions they represent lose market share or shift their assets into better protected (read: less regulated) charters. This dynamic guarantees that even narrow federal efforts to preempt state law will merely *creep*.⁶ In the nearly thirty years since the Supreme Court's decision in *Marquette National Bank v. First of Omaha Corporation*,⁷ preemptive actions have almost without exception crept out to cover more and more commercial activity.⁸ The result has been a steady, silent, deregulatory trend.

One of the most recent manifestations of this preemption creep has been federal banking regulators' efforts to extend immunity from state law to the agents of federal depository institutions. These efforts

PREDATORY LENDING, PHILADELPHIA CODE §§ 9-2400 to 9-2408 (Apr. 9, 2001); DAYTON, OH., CODE OF ORDINANCES §§ 112.40-44 (July 11, 2001); ATLANTA, GA., ORDINANCE 01-O-0843 (June 6, 2001) (codified at ATLANTA, GA., CITY CODE OF ORDINANCES §§ 58-100 to -102 (Sept. 2001)); OAKLAND, CA., ORDINANCE 12361 § 2 C.M.S. (Oct. 2, 2001); CLEVELAND, OH., ORDINANCE 737-02 (Mar. 4, 2002), *amended at* Ordinance 45-03 (Jan. 14, 2003); TOLEDO, OH., ANTI-PREDATORY LENDING ORDINANCE, 291-02 (Nov. 5, 2002) (repealed); L.A., CAL., CAL. FIN. CODE DIVISION § 1.6 (Dec. 18, 2002).

4. Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 72 (2005) [hereinafter *Federalism and Predatory Lending*].

5. *Id.* at 74.

6. *Id.* at 72-73.

7. 439 U.S. 299 (1978) (holding that, under the National Bank Act, a Nebraska bank was permitted to charge out-of-state customers a higher interest rate than their home state would have allowed).

8. My metaphor is by no means the only one. Others have described this process, or at least parts of it, as the perpetuation of a grand illusion, James J. White, *The Usury Trompe l'Oeil*, 51 S.C. L. REV. 445, 445 (2000), and as an "amazing ever-expanding" rubber band, Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518 (2004).

have generated somewhat less commentary than one might expect. Once federal regulators attempted to preempt most state law and oversight for operating subsidiaries, preemption for agents of depository institutions seemed less surprising. In what little has been written on this subject, most scholars have analyzed the legality of the regulatory action.⁹ Still, the preemption creep also produces the following questions: did Congress authorize the Office of Thrift Supervision (the "OTS") and/or the Office of the Comptroller of the Currency (the "OCC") to preempt state law with respect to bank agents?; may the Federal Deposit Insurance Corporation (the "FDIC") preempt state regulation of some state banking activities, including a state's regulation of an out-of-state bank's state licensed agent?; and, would five Justices on the recently reconstituted Supreme Court agree that a federal banking regulator can preempt state regulation of state licensed agents of a state chartered bank? While these are certainly questions that merit attention, this Article focuses instead on the advisability of federal preemption of state regulation of agents of depository institutions as a policy matter.¹⁰ In particular, this Article explores whether economic theory on the relationship between a principle and an agent may hold some useful insights for those pondering the ideal scope of federal preemption of state regulation of depository institutions. Economists and legal scholars have long explored the costs and benefits of agency in a variety of different contexts.¹¹ For example, a significant body of

9. See, e.g., Keith R. Fisher, *Toward a Basal Tenth Amendment: A Riposte to National Bank Preemption of State Consumer Protection Laws*, 29 HARV. J.L. & PUB. POL'Y 981 (2006); Mark A. Olthoff, *National Bank Act Preemption in the Secondary Market*, 123 BANKING L.J. 401 (2006); *Federalism and Predatory Lending*, *supra* note 4, at 82.

10. This focus on economic policy is also justified by the currently unsettled law regarding federal preemption of state regulation of operating subsidiaries of national banks. As this Article goes to press, the Supreme Court is currently deliberating this issue in *Wachovia Bank v. Watters*, 431 F.3d 556 (6th Cir. 2005), *cert. granted*, 126 S. Ct. 2900 (U.S. June 19, 2006) (No. 05-1342). Because the law governing preemption of state regulation of operating subsidiaries and independent agents is comparable, a legal analysis of the latter is not likely to be productive while resolution of the former is pending. Yet a policy analysis of the economic incentives behind preemption for independent bank agents may be especially important now. If the Supreme Court endorses the Office of the Comptroller's ("OCC") attempt to preempt state regulation for operating subsidiaries, the analysis in this Article will be useful in ensuing litigation over preemption for bank agents. On the other hand, if the Supreme Court strikes down the OCC's operating subsidiary rules, the analysis in this Article will be useful in legislative debates that surely will follow.

11. For influential introductions to the application of agency cost theory to law, see generally Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57 (1989); Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7 (1983); JEAN-JAQUES LAFFONT & DAVID MARTIMORT,

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research has developed using agency cost modeling to shed light on corporate law and the nature of the firm.¹² In particular, agency cost theory has been applied to issues such as regulation of middle management,¹³ insider trading,¹⁴ and executive compensation.¹⁵ Legal scholars have also found interesting applications for agency cost theory in jurisprudence,¹⁶ criminal sentencing,¹⁷ antitrust,¹⁸ securities,¹⁹ trusts and estates,²⁰ and tax law.²¹ These theoretical

THE THEORY OF INCENTIVES: THE PRINCIPAL-AGENT MODEL (2002); Eric Posner, *Agency Models in Law and Economics*, in CHICAGO LECTURES IN LAW AND ECONOMICS 225 (Eric A. Posner ed., 2000); and Stephen A. Ross, *The Economic Theory of Agency: The Principals Problem*, 63 AM. ECON. REV. 134 (1973).

12. See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (landmark paper discussing the “nexus of contracts” theory of the firm and highlighting the importance of agency relationships in analyzing it).

13. See Michael J. Meurer, *Law, Economics, and the Theory of the Firm*, 52 BUFF. L. REV. 727, 728-29 (2004) (suggesting that business and the law can be better analyzed by incorporating the theory of the firm into a traditional law and economics discussion).

14. See Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861, 866-72 (1982-83) (proposing that “the insider trading debate is really a debate about whether the firm, as a matter of contract, should be able to allocate property rights in valuable information to managers or to investors”).

15. See Lucian Arye Bebchuck et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 751 (2002) (rejecting the “optimal contracting approach” to executive compensation in favor of an examination of managerial power); William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385, 390 (1988) (arguing in favor of judicial action against opportunistic corporate management where compensation arrangements are unlikely to provide sufficiently strong incentives to align manager and shareholder interests); Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS 2485, 2485 (Orley Ashenfelter & David Cards eds., 1999) (exploring executive compensation through empirical data on executive compensation and turnover); Tod Perry & Mark Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 126 (2000) (suggesting some CEO’s reduce the aligning effect of managerial incentive programs by selling company stock or using derivative contracts to minimize their exposure).

16. See Linz Audain, *The Economics of Law-Related Labor V: Judicial Careers, Judicial Selection, and an Agency Cost Model of the Judicial Function*, 42 AM. U. L. REV. 115, 132 (1992) (questioning “the nature of the mechanisms present in the judicial context to limit divergence of principal-agent interests and/or to limit agency costs”).

17. See Kenneth Dau-Schmidt, *An Agency Cost Analysis of the Sentencing Reform Act: Recalling the Virtues of Delegating Complex Decisions*, 25 U.C. DAVIS L. REV. 659, 661 (1992) (portraying judges as agents who are authorized to carry out the interests of the principal, Congress, in criminal sentencing).

18. See Bruce H. Kobayashi, *Antitrust, Agency, and Amnesty: An Economic Analysis of the Criminal Enforcement of the Antitrust Laws Against Corporations*, 69 GEO. WASH. L. REV. 715, 736 (2001) (using agency cost theory to analyze the criminal liability of corporations with employees that commit illegal acts).

19. See Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1094-1100 (1996) (comparing agency costs of loan origination in traditional lending operations to origination intended for securitization).

20. See Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 648-82 (2004) (applying agency cost theory to a variety of trust doctrines).

questions are considered in the context of the ongoing predatory lending controversy, which continues to rage in the nation's press, courts, and legislatures.

Part I of this Article provides a brief introductory sketch of the predatory lending problem and recent legal developments concerning federal preemption of state authority to address that problem. Part II delivers an exposition of agency cost theory. Part III applies those theories to the financial institution context. It explores whether agents of depository institutions will have the same incentives to avoid predatory behavior as depository institutions themselves and also queries whether federal regulators are prepared to deal with any such disparities in those incentives without the assistance of state law enforcement. Part IV offers brief concluding remarks.

I. BACKGROUND: THE INTERSECTION OF TWO CONTROVERSIES

A. *Predatory Lending In an Era of Financial Deregulation*

Policymakers in all civilizations must face difficult choices about the extent to which public institutions will intervene in credit markets on behalf of debtors. Throughout most of the twentieth century, American consumer credit law was generally rather skeptical of creditors who deployed harsh terms and practices in the origination and collection of consumer debts.²² For example, most states had usury laws that provided some upper limit on the pricing of small loans.²³ And, federal bankruptcy protections chastised overreaching creditors by giving consumers the possibility of a fresh start.²⁴ Moreover, particularly beginning in the mid-1960s, a series of consumer protection initiatives at both the federal and state level were enacted, facilitating a historically unprecedented public

21. See Joseph A. Snoe, *The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax*, 48 U. MIAMI L. REV. 1, 7 (1993) (asserting that because managers have the power to control distributions, while outside investors do not, "Congress should be sensitive to ways to reduce the agency costs resulting from the imposition of the tax").

22. See CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH COST CREDIT MARKET 76-111 (2004) [hereinafter TAMING THE SHARKS] (tracing American consumer credit law as it reacted to cultural and historical changes); Christopher L. Peterson, *Truth, Understanding, and High Cost Consumer Credit: The Historical Context of the Truth-in-Lending Act*, 55 FLA. L. REV. 807 (2003) [hereinafter *Historical Context of Truth-in-Lending*] (tracing the evolution of consumer credit laws leading up to the Truth-in-Lending Act, which calls for increased disclosure to the consumer).

23. BARBARA A. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 15-16 (1965).

24. *Historical Context of Truth-in-Lending*, *supra* note 22, at 866.

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confidence in and acceptance of consumer borrowing.²⁵ However, during the 1980s and largely continuing today, the trend against public intervention in credit markets took force.

A large number of commentators have complained that neglect and relaxation of consumer protection statutes has emboldened a portion of the personal finance industry to engage in a variety of abusive, misleading, and unfair practices loosely grouped under the term “predatory lending.” In general, even the staunchest critics of consumer protection statutes have conceded that a predatory lending problem of some sort exists, although which loans and practices should qualify as such remains a matter of great debate.²⁶

Much of the predatory lending market has been served by non-depository creditors. Traditionally, pawnshops, payday lenders, “buy here-pay here” car dealerships, and rent-to-own financiers have had no relationship with depository institutions. Accordingly, federal and state banking regulators have understandably seen much of the troubling developments in predatory “fringe” markets as a problem outside their jurisdiction, and better addressed by attorneys general, law enforcement, and private litigation.²⁷ But in recent years, several trends have called this assumption into question.

First, mainstream depository institutions have acquired some of the most notorious predatory lenders and currently operate those lenders as subsidiaries. For instance, in 2000 Citigroup acquired Associates First Capital Corporation, a firm dogged by predatory

25. DEE PRIDGEN, CONSUMER CREDIT AND THE LAW § 1:1 (2006)

26. While the purpose of this short Article is not to carefully define the parameters of which types of loans are predatory, there are widely accepted and historically grounded benchmarks upon which a discussion can proceed. For example, in the small loan market, most states continue to retain small loan interest rate caps on their books—although a variety of exceptions have rendered the caps frequently unenforceable. Also, the U.S. Code treats loans at above forty-five percent as a per se evidentiary factor of extortionate criminal loan sharking. 18 U.S.C. § 892(b)(2) (2000). Historically, many ancient governments have capped interest rates at between twenty and thirty-six percent. TAMING THE SHARKS, *supra* note 22, at 51-61. In the market for home mortgages, many states have passed laws which set forth a recipe of terms that can combine to create a predatory loan. For a summary of state predatory mortgage lending statutes see, e.g., Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295, 363-66 (2005); *Federalism and Predatory Lending*, *supra* note 4, at 61-68. To some extent, the Home Ownership and Equity Protection Act was the progenitor of this approach. In other credit markets such as those for home furnishings, cars, or credit cards, there is less consensus on which terms and practices merit the label predatory.

27. See, e.g., COMPTROLLER OF THE CURRENCY ADMINISTRATOR OF NATIONAL BANKS, GUIDELINES FOR NATIONAL BANKS TO GUARD AGAINST PREDATORY AND ABUSIVE LENDING PRACTICES, ADVISORY LETTER NO. 2003-2, at 1-2 (Feb. 21, 2003) (“[T]he OCC does not have reason to believe that national banks or their operating subsidiaries (collectively referred to herein as “national banks”) generally are engaged in predatory lending practices . . .”).

lending allegations for years.²⁸ In 2001 the North Carolina Attorney General's office forced Citigroup into a \$20 million predatory lending settlement.²⁹ In 2002 the Federal Trade Commission forced Citigroup into another predatory lending settlement, this time for \$215 million.³⁰ Although Citigroup promised to clean up its new subsidiary's business practices, allegations of predation have continued to dog the division.³¹ Civil and consumer rights organizations still accuse Citifinancial of predatory lending.³² And, as recently as 2004, the Federal Reserve Board ordered Citigroup to pay a \$70 million fine after a three year investigation turned up additional violations by Citifinancial of the Home Ownership and Equity Protection Act,³³ the Equal Credit Opportunity Act,³⁴ and other predatory lending laws.³⁵

28. See, e.g., *Assocs. v. Troup*, 778 A.2d 529, 537 (N.J. Super. 2001) ("Typically predatory lenders take advantage of borrowers due to their lack of sophistication in the lending market, due to their lack of perceived options for the loan based on discrimination or some other factor, or due to deceptive practices engaged in by the lender that mislead or fail to inform the borrower of the real terms and conditions of the loan. The record in this case indicates that this is consistent with what occurred in the Troup transaction."); Michael Hudson, *Signing Their Lives Away: Ford Profits from Vulnerable Consumers*, in *MERCHANTS OF MISERY* 42, 42-50 (Michael Hudson ed., 1996) (detailing the legacy of abusive lending by Associates); *Citigroup Launches \$200B Loan Program*, CHI. TRIB., Sept. 28, 2003, at 11 (noting that the loan program at issue targeted those who traditionally would have difficulty qualifying for mortgages); Sara Hoffman Jurand, *Household Citigroup Agree to Record Settlements in Predatory-Lending Cases*, TRIAL, Dec. 2002, at 67 (discussing Citigroup's acquisition of Associates First Capital Corp.).

29. *Associates to Refund \$20 Million to North Carolina Mortgagees*, 11(5) CONS. BANKR. NEWS 7 (Oct. 18, 2001).

30. Erick Bergquist, *FTC's Look At Subprime Industry Not Finished Yet*, AM. BANKER, May 25, 2004, at 1. Citigroup's litigation with the FTC proved particularly acrimonious with the FTC publicly accusing Citigroup of stonewalling discovery. Paul Beckett, *FTC Files Motion Against Citigroup In Lending Case*, WALL ST. J., Mar. 6, 2002, at B9 ("[T]he FTC said Citigroup has 'effectively stalled' in producing evidence for the discovery, . . . [and] refused to provide any documents created prior to March 6, 1998, 'even though the FTC intends to prove that the Associates' substantial and widespread illegal lending practices date back to at least January 1, 1994.'").

31. John Gamboa & David Glover, *Viewpoints: To Get Citi to Change Ways, Regulators Need to Do More*, AM. BANKER, Sept. 27, 2002, at 9.

32. See Bergquist, *supra* note 30, at 1 ("[T]he largest settlement in . . . [the FTC's] history [of \$215 million] was hardly a slap on the wrist to Citigroup. The company has assets of over \$1 trillion, so the settlement represented a meaningless percentage of its assets—less than 0.1%. In fact, the settlement is likely to have less of a deterrent effect than a twenty dollar parking fine for a bank official earning \$100,000 a year.").

33. 15 U.S.C. § 1602 (1994).

34. 15 U.S.C. § 1691 (2000).

35. Bd. of Governors of the Fed. Reserve Sys., *In the Matter of Citigroup, Inc.*, Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent (May 27, 2004); Erick Bergquist, *Citi-Fed Pact on Subprime: Opening Act?* AM. BANKER, May 28, 2004, at 1; Timothy L. O'Brien, *Fed Assesses Citigroup Unit \$70 Million in Loan Abuse*, N.Y. TIMES, May 28, 2004, at C1.

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Second, many commentators have pointed to increasingly onerous and deceptive pricing in mainstream banking products.³⁶ As the lines between the fringe and prime markets have blurred, mainstream lenders have turned to terms and practices which are gradually approaching a point which reasonable independent observers might describe as predatory. For example, there have been widespread complaints about credit card default interest rates of more than thirty percent.³⁷ Moreover, many are skeptical of universal default terms where a late payment on some other obligation, such as the consumer's rent or a medical bill, can trigger the default interest rate on a credit card that the consumer has always paid on time.³⁸ Consumer advocates complain of bait and switch advertising in which credit card issuers unilaterally change contract terms shortly after origination.³⁹ Finally, the increasing use of mandatory arbitration clauses and waivers of the right to pursue remedies in a class action may deprive consumers of a realistic opportunity to create case law inhibiting these sharp practices.⁴⁰ Collectively, these developments and others like them⁴¹ have made many mainstream banking products appear quite similar to financial agreements traditionally found on the fringe market.

Third, for several years, fringe and predatory lenders have sought to obtain their own banking charters. In recent months, at least two appear to have succeeded in doing so. Consumer advocates' fears seem well grounded now that the OTS has extended a thrift charter to H&R Block, the largest tax return preparer in the country.⁴² For years, consumer groups have been troubled by loan pricing and

36. See Elizabeth Warren, *Bankrupt Children*, 86 MINN. L. REV. 1003, 1025-26 (2002) (discussing the impact of credit card debts on children of bankrupt consumers).

37. Kathy Chu, *Shouldering Mega Credit Card Fees?*, USA TODAY, Nov. 18, 2005, at 3B; Kathleen Day & Caroline Mayer, *Credit Card Penalties, Fees Bury Debtors; Senate Nears Action on Bankruptcy Curbs*, WASH. POST, Mar. 6, 2005, at A1.

38. Patrick McGeehan, *Plastic Trap—Debt That Binds: Soaring Interest is Compounding Credit Card Woes for Millions*, N.Y. TIMES, Nov. 21, 2004, at A1.

39. Carolyn Carter et al., *The Credit Card Market and Regulation: In Need of Repair*, 10 N.C. BANKING INST. 23, 42 (2006).

40. *Id.* at 45-46.

41. Another troubling example is bounce protection plans on checking accounts that, in effect, charge interest rates comparable to payday loans to consumers who overdraw their checking accounts. Owen B. Asplundh, *Bounce Protection: Payday Lending in Sheep's Clothing*, 8 N.C. BANKING INST. 349, 350 (2004). Consumer groups have complained that some banks charge bounce protection fees to consumers withdrawing money at ATM machines who do not realize they are overdrawing their account. Laura K. Thompson, *Bank Overdraft Programs Rankle Consumer Groups*, AM. BANKER, May 20, 2003 at 4.

42. Jody Shenn, *H&R Block: As OTS Oks Charter Bid, Spitzer Sues*, AM. BANKER, Mar. 16, 2006, at 1.

inflated fees charged by H&R Block.⁴³ They have accused H&R Block of deceptively marketing its loan products as quick tax returns, rather than as the low risk triple-digit interest rate loans they really are.⁴⁴ Similarly, the largest pawn shop chain in the State of Minnesota has successfully obtained an industrial loan charter.⁴⁵ While industrial loan corporations are something of an unusual breed of bank in most of the country, in some states which authorize them, including especially Utah, the favorable charters have facilitated non-depository institutions in obtaining some of the same interest rate exporting capabilities as depository lenders.⁴⁶ Moreover, with the likes of Wal-Mart pushing for its own industrial loan corporation, fringe lenders with a history of predatory lending seeking the same thing may have an extremely powerful ally.⁴⁷

Finally, many banking institutions in the United States have not been shy about using agents to originate and service predatory loans. Many of the most powerful fringe credit businesses in the country have used the imprimatur of federal banking regulators in making loans with interest rates over *ten times* the federal forty-five percent per se evidentiary trigger for extortionate loan sharking.⁴⁸ For years,

43. See Damian Paletta, *Tax Refund Loans Called Predatory*, AM. BANKER, Feb. 1, 2002, at 5 (referencing H&R Block's policy of offering a loan against its customers' tax refunds for a fee of twenty nine to eighty nine dollars); CHI CHI WU, JEAN ANN FOX & ELIZABETH RENUART, TAX PREPARERS PEDDLE HIGH PRICED TAX REFUND LOANS: MILLIONS SKIMMED FROM THE WORKING POOR AND THE U.S. TREASURY 12 (Consumer Federation of America & National Consumer Law Center, January 31, 2002) (calculating the profits earned by H&R Block as a result of its traditional and new electronic refund anticipation loan programs).

44. Much of the consumer group outrage over tax return loans stems from the fact that unlike many consumer loans, these products are low-risk, since the tax preparer is certain to receive a tax return check from the federal government. TAMING THE SHARKS, *supra* note 22, at 231-33. To the extent that there is repayment risk, it stems from the tax preparer's own errors in preparing the consumer's return documents. Also, H&R Block has been criticized for skimming millions of dollars out of the government's earned income tax credit, the most important remaining poverty entitlement program designed to lift children out of poverty. WU, FOX, & RENUART, *supra* note 43, at 8-10. Apparently, these concerns did not deter the OTS from granting H&R Block a federal banking charter and the preemption rights that go along with it.

45. Sheryl Jean, *Pawnbroker to Banker? The Leading Provider of Payday Loans to Cash-Strapped Minnesotans Expands its Financial Services—But Consumer Advocates Aren't Happy*, ST. PAUL PIONEER PRESS, Apr. 2, 2006, at D1.

46. ILCs—A Review of Charter, Ownership, and Supervision Issues: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services, 109th Cong. (2006), available at <http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=487>.

47. See generally Kevin K. Nolan, *Wal-Mart's Industrial Loan Company: The Risk to Community Banks*, 10 N.C. BANKING INST. 187 (2006) (summarizing Wal-Mart's efforts to enter the banking industry).

48. 18 U.S.C. § 892(b)(2) (2000) (defining extortionate extensions of credit as those that are "made at a rate of interest in excess of an annual rate of 45 per

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bank regulators facilitated predatory payday lending by allowing both state and federal banks to make predatory payday loans out of fringe lending company store fronts.⁴⁹ It is true that the OCC and now more equivocally the FDIC have used their regulatory discretion to curtail payday lending by banks with the cooperation of fringe agents.⁵⁰ Nevertheless, great damage was done to the fabric of American consumer protection law in the interim. By allowing out-of-state banks to make payday loans, local lenders could demand equal treatment from state legislators undermining usury laws one legislature at a time, all across the country.⁵¹ Meanwhile, at least for a time, fringe lenders with patron banks (with, in turn, a patron bank regulator) profited without concerning themselves with these ugly state political battles.

As a result of the foregoing trends, the assumption that the predatory lending market has been served by non-depository creditors may no longer be legitimate. In fact, the trends described above demonstrate that as depository institutions begin to participate in the fringe market and utilize practices that many consider to be predatory, the lines between predatory fringe lending and traditional lending have become blurred.

B. Preemption in an Era of Consolidating Federal Power: The Case of Agents of Depository Institutions

Collectively these trends, which all suggest that depository institutions may be growing closer to fringe market players and practices, have set a troubling stage for debates over federal preemption to play upon. Non-profit consumer advocacy

centum . . . pursuant to which a payment is applied first to the accumulated interest and the balance is applied to the unpaid principal").

49. See generally CONSUMER FEDERATION OF AMERICA & U.S. PUBLIC INTEREST RESEARCH GROUP, RENT-A-BANK PAYDAY LENDING: HOW BANKS HELP PAYDAY LENDERS EVADE STATE CONSUMER PROTECTIONS 2 (Nov. 2001) (providing a survey on state by state payday lenders and finding that both federal bank regulators and state attorneys general oppose the "rent-a-bank" trend).

50. Erick Bergquist, *FDIC Payday Stance May Narrow Field Further Still*, AM. BANKER, Mar. 17, 2005, at 1 (noting that new regulations could increase the cost of payday lending for depositories, cutting back the payday loan volume by almost twenty-five percent); Annys Shin, *On Payday, Many GIs Pay Back; Military Members Face Long-Term Costs for Short-Term Borrowing*, WASH. POST, Sept. 10, 2006, at F1 (discussing the Pentagon's proposal to protect active military personnel by placing a cap on the annual rate payday lenders can charge).

51. See Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653, 659 (2005) (concluding that the only way to prevent payday lenders from targeting members of the armed forces is by pursuing criminal prosecution of state usury laws).

organizations have been highly critical of federal preemption, as have state attorneys general. Consistent with these concerns, many commentators have worried that federal preemption of various aspects of the consumer finance system will undermine momentum needed for reform of consumer protection law. For example, Arthur Wilmarth has argued that the OCC's efforts to create field preemption are an illegal and cynical power grab that will come at the expense of consumers.⁵² Bahir Azmy recently argued that state level predatory mortgage lending reform is a positive example of the states as laboratories of democracy in action.⁵³ Robert Eager and C.F. Muckenfuss have described how state predatory mortgage lending statutes created a vehicle for federal banking regulators to issue orders preempting those statutes which gave an adumbrative competitive advantage to federal institutions over their state chartered counterparts.⁵⁴ Margot Saunders and Alys Cohen have gone as far as to suggest that federal regulation is better seen as a cause of predatory lending than a hedge against it.⁵⁵ I have speculated that because federal regulators are aware of state parity laws and the incentive of states to protect their own institutions, perhaps efforts to preempt have more to do with a deregulatory agenda than an effort to change the balance of power in the dual banking system.⁵⁶

Many in the banking industry, banking regulators in particular, have responded with formidable arguments on the necessity of federal preemption. For example, Julie Williams and Michael S. Bylsma from the OCC have argued that federal preemption is

52. Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, 247-53 (2004).

53. Azmy, *supra* note 26, at 391.

54. Roger C. Eager & C.F. Muckenfuss, III., *Federal Preemption and the Challenge to Maintain Balance in the Dual Banking System*, 8 N.C. BANKING INST. 21, 27-31 (2004).

55. Margot Saunders & Alys Cohen, *Federal Regulation of Consumer Credit: The Cause or the Cure for Predatory Lending?* (Harvard University Joint Center for Housing Studies Working Paper Series, March 2004) at 17 (concluding that federal laws provide an excuse for the reduction in critical protections afforded to consumers by states). Federal regulation has been ineffective because it fails to provide any real incentive for creditors to stop making loans which hurt consumers. *Id.*

56. *Federalism and Predatory Lending*, *supra* note 4, at 96-97. Indeed rules currently under consideration by the FDIC appear to support this notion. The FDIC is considering moving to restore balance in the dual banking system by simply loosening regulation on state banks to mirror the immunity of federally chartered institutions. If this approach works its way into the law, the result of preemption will not be a competitive advantage for one group of financial institutions, but less consumer protection overall without the nuisance of passing embarrassing congressional legislation.

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necessary in an increasingly national financial services marketplace.⁵⁷ They have also pointed out that federal banking regulators have replaced state law and enforcement with federal banking regulations that are sufficient to prevent consumer abuse.⁵⁸ Moreover, federal regulators have expressed skepticism over whether federal banking institutions have actually been involved in predatory practices.⁵⁹ Credit rating companies, such as Standard and Poor's and Moody's, have buttressed these arguments by refusing to rate securities, including loans, from jurisdictions that adopt aggressive anti-predator liability rules.⁶⁰ Fringe lender trade associations have tried to polish their public image by hiring expensive public relations firms, some of which have a track record of aggressive, bare knuckle political advocacy.⁶¹

A still emerging front in this national debate is whether banking regulators can and should preempt state law with respect to non-bank agents of banking institutions. By way of background, in recent years depository institutions have increasingly turned to outside contractors to complete a variety of tasks associated with banking

57. Julie L. Williams & Michael S. Bylsma, *Federal Preemption and Federal Banking Agency Responses to Predatory Lending*, 59 BUS. LAW. 1193, 1193 (2003-2004) ("[T]oday's credit and financial markets are as national in scope as our highway system. Just as the value of a uniform interstate highway system to support our nation's commerce is well recognized, the value of a uniform national system for provision of financial services is coming to be so.").

58. *Id.* at 1194-1200 (detailing the various new safeguards that the OCC implemented to address predatory lending).

59. Office of the Comptroller of the Currency, *Economic Issues in Predatory Lending*, Unpublished OCC Working Paper, July 30, 2003, at 4, available at <http://www.occ.treas.gov/workingpaper.pdf>.

60. Natalie Abrams, et al., *Standard and Poor's Implements Credit Enhancement Criteria and Revises Representation and Warranty Criteria for Including Anti-Predatory Lending Law Loans in U.S. Rated Structured Finance Transactions* (May 13, 2004), http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/sp_article/ArticleTemplate&c=sp_article&cid=1093998408709&b=10&t=2&l=EN; Erick Bergquist, *Ga. Amended Predator Law After Preapproval by S&P*, AM. BANKER, Mar. 11, 2003, at 1.

61. Compare Press Release, Steven Schlein & Jay Leveton, *For Immediate Release: Less Than 4 Percent of Military Have Taken a Payday Advance Loan Says New Survey*, Feb. 3, 2004 (on file with author) (press release issued on behalf of payday lender trade association), with Glen Martin, *Chemical Industry Told to Get Tough: Lobbyist's Memo Advises Hardball Tactics for Fighting Tighter California Regulations*, S.F. CHRON., Nov. 21, 2003, at A21 ("They're known for creating deceptive, phony front groups," Walker said. "They go through people's trash; they make a policy of hiring former FBI and CIA operatives. Their motto basically is that they're not a PR firm-you hire them when you want to win a war." . . . Steven Schlein, a senior vice president with Nichols-Dezenhall, defended the firm's tactics. "We may be aggressive in the service of our clients, but we never break the law," he said."); see also Eamon Javers, *"The Pit Bull of Public Relations": Eric Dezenhall serves clients such as ExxonMobil by Going After their Foes*, BUS. WK., Apr. 17, 2006, at 84 ("Journalist Bill Moyers, who tangled with Dezenhall's firm over a 2001 documentary about the chemicals industry, says: 'I consider them the Mafia of industry.'").

activity.⁶² For example, depository institutions have hired independent companies to conduct a variety of routine banking functions such as data processing, accounting, maintaining computer network security, and human resource administration.⁶³ But depository institutions have also increasingly outsourced many tasks involving interaction with their customers, such as operating telephone call centers and bill paying services.⁶⁴ Some depository institutions have also hired independent contractors for loan brokering, loan servicing, real estate appraising, telemarketing, and direct mail solicitation on behalf of the depository institution.⁶⁵

Depository institutions hire independent contractors to act as agents on behalf of the institutions for a variety of reasons. One advantage of using independent contractors is avoiding sunken costs from excess labor capacity when business is slow. When business picks up, depository institutions can quickly and flexibly respond through independent contractors to whom the institution lacks a long-term commitment. Independent contractors are also responsible for their own benefits and health care—an increasingly important component of employee compensation given recent skyrocketing health care costs. Independent contractors that specialize in a particular banking activity may also develop special expertise allowing them to complete tasks more quickly and efficiently. Moreover, in an era of bank mergers and acquisitions, long-term commitments to employees can reduce the flexibility of the institutions as they posture for the most advantageous capital structure.⁶⁶

62. See generally Lavonne Kuykendall, *Market Changes, New Focus May Have Led NPC to Block*, AM. BANKER, June 2, 2004, at 7 (discussing independent contractors in payment system banking); Jody Shenn, *A Strategy Fix for RBC Mortgage: New Compensation Structure Meant to Put Focus on Margins*, AM. BANKER, Apr. 1, 2004, at 1 (considering new industry practices with respect to loan origination).

63. See, e.g., OFFICE OF THRIFT SUPERVISION, DEPARTMENT OF TREASURY, THIRD PARTY ARRANGEMENTS, THRIFT BULLETIN TB 82a (Sept. 1, 2004) (clarifying the role of “significant” contracts with third-party firms and modifying the notification requirements for companies that use outside service providers); Karen Gullo, *Outsourcing Poses Dilemma for Strategists*, AM. BANKER, June 27, 1990, at 1 (noting that outsourcing is generally a useful tactic for small to medium-size banks that cannot afford to keep up with cutting-edge banking and data processing technology); James H. McKenzie & Jeb Britton, III, *Should You Heed the Siren Song of Third-Party Firms?*, ABA BANKING J., Oct. 1996, at 99 (describing the role of third-party firms in providing employee benefits and related services).

64. OFFICE OF THRIFT SUPERVISION, DEPARTMENT OF TREASURY, THIRD PARTY ARRANGEMENTS, THRIFT BULLETIN TB 82a (Sept. 1, 2004).

65. Orla O’Sullivan, *The Profitability Riddle: We Know What it is Not, But Not What it is*, ABA BANKING J., Feb. 1998, at 78.

66. See Lee Conrad, *Loan Muscle Wears a Tie Now, Works Phones, Makes \$\$: Market Shakeout Leaves 20 Agencies as Major Players, and with little Bank Competition, They’re*

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However, one potential drawback of independent contractors has been regulatory. As federal regulators have carved out protection for their constituent institutions from state oversight and law, federal depository institutions have found a competitive advantage by avoiding the necessity of state licensing fees, state inspections, and also (more controversially) the application of many state consumer protection laws. This has created an issue of whether state law and regulatory authority apply to independent contractors of federal depository institutions. On one hand, an independent contractor is just that: independent. Agents of depository institutions are not themselves depository institutions. On the other hand, banking regulators have been reluctant to force depository institutions into less efficient capital structures for no good reason. What difference should it make whether a bank or thrift conducts its marketing or customer service through employees or through agents? Why should the latter be subject to state law and authority when the former is not? Finding no source of concern from these questions, federal banking regulators have taken a series of steps which either explicitly or implicitly have allowed agents of depository institutions to attempt to avoid state legal and regulatory authority under the guise of federal preemption.

To date, the OTS has made the most explicit effort to preempt state law and oversight with respect to non-depository agents of federal depository institutions. In October 2004, the OTS general counsel's office issued an opinion letter responding to an inquiry from a federal savings association and its wholly owned subsidiary.⁶⁷ The thrift in question wanted to know whether independent agents it had hired to perform marketing, solicitation, and customer service on loan products were "subject to state licensing or registration laws by reason of performing such activities on behalf of, and as agents for, the Association."⁶⁸ The thrift in question had entered into contracts with the independent businesses to market the thrift's loans through direct mail, telephone, and personal contacts. The independent contractors also assisted loan applicants in completing application forms, answering questions, forwarding completed

Going After a Mountain of Late Debts. First Order of Business, Set Up Shop in India, U.S. BANKER, May 13, 2004, at 46 (surveying new trends in debt collection, including "debt buying").

67. OP. CHIEF COUNSEL, OFFICE OF THRIFT SUPERVISION, AUTHORITY OF A FEDERAL SAVINGS ASSOCIATION TO PERFORM BANKING ACTIVITIES THROUGH AGENTS WITHOUT REGARD TO STATE LICENSING REQUIREMENTS, P-2004-7 (Oct. 25, 2004), 2004 OTS LEXIS 6 [*hereinafter* OTS, P-2004-7].

68. *Id.* at *2.

applications to the thrift, and other various customer service duties.⁶⁹ The independent contractors had exclusive representation arrangements where they did not provide similar services to any other lender. They received compensation based on the number of transactions “actually consummated” by the thrift.⁷⁰ The source of controversy behind the opinion letter was the fact that many states had required the independent contractors performing mortgage brokering services to register, obtain licenses, and otherwise comply with the state’s mortgage brokerage licensing statute.⁷¹

In response to the inquiry, the OTS reasoned that thrifts were entitled to the freedom to make business decisions on how to conduct their operations.⁷² It explained that thrifts should not be subject to state law simply because they chose to use an independent contractor rather than one of their own employees.⁷³ Still, the administrative action is at least partially explained by the massive financial interest at stake. According to an influential insurance industry trade publication, over fifty insurance companies now own institutions with federal banking charters.⁷⁴ The largest of these insurance companies is State Farm, which owns State Farm Bank, a thrift regulated by the OTS.⁷⁵ Under the OTS opinion letter, State Farm’s approximately 17,000 insurance agents—all of whom are already subject to state insurance law—are purported to be free from state mortgage lending regulatory licensing and oversight in marketing home mortgages to their insurance clients.⁷⁶ In addition to significantly decreasing State Farm’s regulatory oversight, the opinion also coincidentally increased the power base of the OTS.⁷⁷

For its part, the OCC issued a similar regulatory preemption determination in 2001.⁷⁸ While the OCC’s provision is rather less

69. *Id.* at *4.

70. *Id.* at *6.

71. *Id.* at *9.

72. *Id.* at *34.

73. *Id.*

74. *State Farm Receives Federal Bank Charter*, BEST’S INS. NEWS, Dec. 16, 2004.

75. *State Farm Digging in Its Heels Over Regulatory Ruling*, BEST’S INS. NEWS, Dec. 17, 2004.

76. *Id.*; see OTS, P-2004-7 *supra* note 67, at *14 (declaring that federal savings associations may operate as deposit and lending institutions without regard to state licensing and registration requirements).

77. See OTS, P-2004-7, *supra* note 67, at *15-16 (“[M]arketing and solicitation are subject to regulation by OTS. A state may not put operational restraints on a federal savings association’s ability to offer an authorized product or service by restricting the association’s ability to market its products and services and reach potential customers.”).

78. See Preemption Determination, 66 Fed. Reg. 28593, 28595 (Dep’t of the Treasury May 23, 2001) [hereinafter OCC Car Dealership Preemption Letter] (deciding that federal law preempts the Michigan Motor Vehicle Sales Finance Act,

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explicit in its reasoning, it makes up for this in sheerchutzpah. The regulation purports to preempt the application of state consumer protection law and authority to used car dealerships (of all businesses) where they are acting as an agent of a national bank.⁷⁹ While there is no question that car dealerships provide an important, indispensable, and legitimate service to Americans, there is also no denying that automobile sales present one of the most notoriously treacherous personal finance situations faced by American consumers.⁸⁰ The state statute in question, the Michigan Motor Vehicle Sales Finance Act of 1950,⁸¹ which dates back to the Truman administration, was designed to attempt to rein in some of the abusive car dealership practices faced by Michigan residents. To this end, the statute required that “a person shall not engage in this state as a[n] . . . agent” in “the business of an installment seller of motor vehicles under installment sale contracts” without a license.⁸² Car dealers in Michigan are also required to put up a bond to cover liability to the state or consumers victimized by unlawful behavior,⁸³ and to make available their records to the state Financial Institutions Bureau.⁸⁴ Moreover, the statute includes a variety of consumer protection provisions including price disclosures,⁸⁵ the prohibition of some potentially abusive contractual terms,⁸⁶ rules attempting to prevent unfair or coercive insurance sales in connection with car sales,⁸⁷ and limits on the type of junk fees dealers can charge.⁸⁸ Finally, the statute also limits the interest rate on car loans where a car dealer itself is offering the loan or is acting as a broker or agent for the lender.⁸⁹

The OCC’s ruling resulted from a dispute about an agreement between National City Bank, a national bank located in Ohio, and a

because the Michigan law conflicts with “OCC’s exclusive visitatorial powers over national banks”).

79. *Id.*

80. See, e.g., Michael Feyen, *Showroom Turncoat Comes Clean: Dirty Dealing Exposed, and How Not to Get Taken to the Cleaners When Buying a Car*, CAR & DRIVER, May 2006, at 94 (describing remorse felt by a former car salesman over past dealings with naïve customers).

81. MICH. COMP. LAWS § 492.103 (2005).

82. *Id.*

83. *Id.* § 492.105.

84. *Id.* § 492.110.

85. *Id.* § 492.113.

86. See *id.* § 492.114 (including provisions on acceleration clauses, clauses waiving legal rights, clauses granting the dealership the power of attorney, and clauses waiving of assignee liability for the dealer’s unlawful behavior).

87. *Id.* § 492.116.

88. *Id.* §§ 492.117, 492.131.

89. *Id.* § 492.118.

car dealership in Michigan.⁹⁰ Under the agreement, the dealer was to serve as a limited agent on behalf of the bank in soliciting car loans, taking applications, preparing loan documentation, and closing the loans by obtaining the consumer's signature on all the required documents.⁹¹ National City Bank agreed to compensate the car dealer by paying a commission on each loan closed.⁹² Under the contract, the bank had exclusive authority to approve loans, but the dealership was free to charge interest rates in excess of those required by the bank's underwriting guidelines.⁹³ When customers agreed to interest rates inflated beyond the bank's risk-based underwriting standards, the bank offered a kick-back, sometimes called a yield spread premium, to the dealer in addition to the normal commission.⁹⁴ In such arrangements, the car dealer or mortgage broker receives compensation in addition to a base commission in exchange for originating an "above par" loan—that is, a loan with a higher interest rate than the borrower qualifies for based on the lender's own guidelines.⁹⁵ Consumer advocates and scholars have criticized this type of yield spread premium as one of the most important indicia of predatory lending.⁹⁶ Some empirical research suggests that minority and women borrowers end up paying higher interest rates where a lender and its agent sets up this type of relationship.⁹⁷ Moreover, even when disclosed, this type of compensation is deceptive and confusing because borrowers rarely suspect that they will be charged an extra fee for the privilege of a

90. DEP'T OF CONSUMER AND INDUSTRY SERVICES- FINANCIAL INSTITUTIONS BUREAU, IN THE MATTER OF: REQUEST BY RODNEY D. MARTIN (Jan. 1, 2000), http://www.michigan.gov/cis/0,1607,7-154-10555_20594_20597-51126-,00.html (declaratory ruling) [hereinafter Michigan Financial Institutions Bureau Ruling]; OCC Car Dealership Preemption Letter, *supra* note 78, at 28593-94.

91. OCC Car Dealership Preemption Letter, *supra* note 78, at 28593.

92. Michigan Financial Institutions Bureau Ruling, *supra* note 90.

93. *Id.*

94. *Id.*

95. TAMING THE SHARKS, *supra* note 22, at 142; Brian A. Wahl, *Yield Spread Premium Class Actions Under RESPA: Confusion Predominates*, 19 REV. LITIG. 97, 98 n.1 (2000).

96. See *Predatory Mortgage Lending Practices: Abusive Use of Yield Spread Premiums: S. Hearing 107-857 before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 22-23 (2002) (statement of Ira Rheingold, Executive Director, Nat'l Ass'n of Consumer Advocates) (testifying on the exploitative nature of yield spread premiums that are used against unsuspecting consumers); Brian Collins, *Consumer Groups Still Pushing Hard on RESPA*, ORIGINATION NEWS, May 1, 2006, at 81 (reporting consumer groups' arguments that the extra fees associated with yield spread premiums are hardest on the most naïve consumers).

97. See generally Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums 3* (Jan. 8, 2002) (unpublished manuscript, on file with author).

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higher interest rate.⁹⁸ Yield spread premiums give the broker or dealer the flexibility to target unsophisticated or trusting borrowers with sometimes ruinous prices, while still not losing borrowers who are more responsive to price competition.

Rather than simply complying with the statute—like other lenders and car dealers in Michigan—National City and its agent petitioned the Michigan State Financial Institutions Bureau for a declaratory ruling stating that the law did not apply to the bank, nor to the car dealership with whom it had contracted.⁹⁹ Understandably, the Michigan agency refused to waive the application of the state motor vehicle installment sales law to the car dealership simply because the dealer signed a contract with an out-of-state bank.¹⁰⁰ In its ruling, the Bureau did not contest that National City Bank was free to charge Ohio interest rates in direct loans to borrowers. Rather, the Bureau reasoned that when a national bank originated loans *through car dealerships*—business entities chartered, licensed, and regulated by the State and seemingly well beyond the scope of the Riegle-Neal Act¹⁰¹—those dealerships were nevertheless obliged to comply with the commands of the Michigan legislature.¹⁰² After all, the Supreme Court has not, at least not yet, announced a “most favored used car dealer” doctrine.¹⁰³

Nevertheless, when National City Bank later asked the OCC for an opinion that would circumvent the Michigan regulator’s decision, the OCC obliged. In making its case, the OCC began with the truisms that national banks are authorized to make loans and to use agents in

98. TAMING THE SHARKS, *supra* note 22, at 144 (describing yield spread premiums as particularly insidious “[s]ince the borrower never knows about the yield spread premium, the broker can still collect up-front cash compensation from the borrower in addition to the yield spread premium which is paid through the loan proceeds”).

99. Michigan Financial Institutions Bureau Ruling, *supra* note 90.

100. *See id.* (finding that Michigan laws apply to contracts between Michigan residents and out-of-state banks).

101. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified in scattered sections of 12 U.S.C.) (removing state erected barriers to nationwide banking operations).

102. Michigan Financial Institutions Bureau Ruling, *supra* note 90. The Bureau explained:

Where a bank licensed under the Act has engaged a licensed installment seller as an agent to facilitate the making of installment sale contracts, the agent must not only maintain licensure under the Act, but must endure that the installment sale transaction that it is facilitating is conducted in full compliance with the Act. Where such agent has facilitated the making of an installment sale contract and that transaction does not comply with the Act, that agent may be subject to an administrative enforcement action as well as any applicable criminal sanction.

Id.

103. *Cf. Tiffany v. Nat’l Bank of Mo.*, 85 U.S. 409, 413 (1873) (announcing the most favored lender doctrine in interpreting Section 85 of the National Bank Act).

connection with their business.¹⁰⁴ Moreover, the OCC pointed out that under the *Marquette* Doctrine,¹⁰⁵ national banks are free to charge interest rates in accordance with the laws of the bank's home state.¹⁰⁶ From these three premises the opinion letter concludes that, "in our opinion, Federal law preempts the [Michigan Motor Vehicle Sales Finance Act] . . . because the statute, as interpreted, conflicts with Federal law authorizing the Bank to engage in the activities in question and with the OCC's exclusive visitorial powers over national banks."¹⁰⁷

Aside from being something of a grating non sequitur, the letter never points to any specific statutory language from Congress authorizing the OCC to prevent Michigan from imposing consumer protection law on its car dealerships. Also noticeably absent from the OCC's determination was any mention of the arguably predatory yield spread premium-based compensation National City Bank intended for its car dealer/agent.

Given the potentially far-reaching annulment of cumbersome state consumer protection law and regulatory oversight, it should come as no surprise that state depository institutions have become envious of the immunity from state law enjoyed by federal lenders. In 2005, the Financial Services Roundtable petitioned the FDIC to issue a rule granting sweeping preemption of state law to state chartered banks.¹⁰⁸ After a public hearing on the subject, the FDIC issued a notice of rulemaking proposing to adopt much of the policy suggested by the roundtable.¹⁰⁹ However, at the time of this writing, the FDIC had not yet acted on the proposed rules.¹¹⁰ Like previous actions by the OTS

104. See OCC Car Dealership Preemption Letter, *supra* note 78, at 28595 ("First, section 24 (Seventh) specifically authorizes national banks to make loans. . . . Second, the authority of national banks under section 24 (Seventh) permits a national bank to use the services of agents and other third parties in connection with a bank's lending business.").

105. See *infra* note 114 and accompanying text (describing the Court's creation of the most favored lender doctrine).

106. See OCC Car Dealership Preemption Letter, *supra* note 78, at 28595 ("Finally, under 12 U.S.C. § 85 (2000), national banks may charge interest in accordance with the laws of the state where the bank's main office is located without regard to where the borrower resides and despite contacts between the loan and another state.").

107. *Id.*

108. The Roundtable petitioned the FDIC to adopt rules designed to provide parity between state banks and national banks, by regulating state banks and their subsidiaries. See Interstate Banking and Federal Interest Rate Authority, 70 Fed. Reg. 60019, 60019 (proposed Oct. 14, 2005) (to be codified at 12 C.F.R. pts. 331 & 362).

109. *Id.*

110. The proposed FDIC rules have put state banking regulators in something of a quandary. Ethan Zindler, *State Agencies Divided On FDIC Preempt Plan*, AM. BANKER, Dec. 22, 2005, at 1. On the one hand, they risk losing influence over financial institutions in their states if state banks shift into federal charters. *Id.* On the other

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and OCC, the FDIC's proposed rules will inevitably force the agency to take a position on preemption with respect to agents of state banks. For now at least, the FDIC's proposed rules do not specifically address whether preemption will also apply to independent contractors of state banks. Rather the proposed rules make preemption for out-of-state, state banks coextensive with the preemption given to national banks. The proposed rule states:

[A]n out-of-State, State bank that has a branch in a host State may conduct any activity at such branch that is permissible under its home state law if it is either:

- (1) Permissible for a bank chartered by the host State, or
- (2) Permissible for a branch in the host State of an out-of-State, national bank.¹¹¹

Under the FDIC's proposed rules, preemption for state banks is coextensive with preemption for national banks, as determined by the OCC. Therefore, given the OCC's ruling on agents, it seems that the proposed FDIC rules will preempt the application of state law to state licensed agents of an out-of-state, state bank.

Even more puzzling, if the proposed FDIC rules are adopted, it seems that the consumer protection laws of a state bank's *own* state will not apply to independent bank agents otherwise licensed by that state. After all, virtually all states have wild card parity laws for their own state chartered banks.¹¹² These rules purport to give every power to local banks that out-of-state banks have under federal law. Thus, under the proposed FDIC rules, unless the courts refuse to play along, a synthesis of federal banking regulations and state law would appear to allow any depository institution to engage any independent contractor to make and service loans with immunity from state oversight and consumer protection laws.¹¹³ Who could have foreseen

hand, some regulators have opposed the rules for fear that they will weaken their regulatory authority by creating still more incentive for banks to relocate to states with weak regulation. *Id.*

111. Interstate Banking and Federal Interest Rate Authority, 70 Fed. Reg. 60019, 60031 (proposed Oct. 14, 2005) (to be codified at 12 C.F.R. pt. 362.19(d)).

112. NATIONAL CONSUMER LAW CENTER, THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES § 3.11.1 (2d ed. 2000); Eager & Muckenfuss, *supra* note 54, at 66-67; John D. Hawke, Jr., Comptroller of the Currency, Remarks before Meeting of Women in Housing and Finance 7-8 (Sept. 9, 2003), *available at* <http://www.occ.treas.gov/ftp/release/2003-69a.pdf>.

113. Presumably state laws that have only an incidental relationship to a bank's or thrift's authorized powers would not be preempted. But, we might translate this into 'state laws are not preempted, unless they actually protect a consumer from something.' This is small consolation indeed.

the bickering and mischief made inevitable when the Supreme Court first picked its “most favored” lender?¹¹⁴

As of yet, the judicial branch has not yet taken a clear position on whether federal preemption extends to independent agents of depository institutions. But eventually this issue should work its way into the courts. When it does there will be occasion for careful reflection on the advisability of the regulators’ position. Obviously the text of the Riegle-Neal Act and Congressional intentions with respect to the agents of depository institutions will play the central role in this litigation. Nevertheless, courts (and banking regulators) must interpret Congressional statutes with a sanguine eye to the actual policy implications of their decisions. In the next Part, I describe how agency cost theory may hold some insight in analyzing this question.

II. AGENCY COST THEORY

The complexity of agency relationships has created a fertile field for legal and economic analysis.¹¹⁵ A principal and an agent form an agency relationship because they each expect to receive some net benefit. The parties expect that the relationship will lead to an efficient division of labor. Thus, a principal might benefit from the greater expertise of an agent, such as where shareholders of a corporation hire managers to skillfully oversee their ownership interest in the firm. Similarly, agency relationships allow investment in many different productive enterprises, which allows those with wealth to diversify their holdings, thereby insulating them from unforeseeable risks inherent in any one given venture. Sometimes principals seek agents where the principal recognizes, *ex ante*, the

114. In *Tiffany*, the Supreme Court asserted that national banks are “national favorites.” 85 U.S. 409, 413 (1873). This label subsequently evolved into a “most favored lender” doctrine. See *Marquette Nat’l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299, 314 n.26 (1978) (observing that “most favored lender” status for national banks had been incorporated into regulations promulgated by the Comptroller of Currency).

115. Economists have generally used a far more inclusive definition of agency relationships than does the law. For example, Stephen Ross defined agency relationships as arising “between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal in a particular domain of decision problems.” Ross, *supra* note 11, at 134. For economists, even contractual arrangements between an employer and employee are sometimes viewed through the lens of agency cost theory. *Id.* This Article does not intend to contribute to economic agency theory as such, nor does it hope to examine every conceivable agency relationship, as broadly construed, that might arise within the context of financial institutions. Rather, it hopes to mine agency cost theory for useful insights on the question of extending federal preemption of state law for independent contractors of depository institutions.

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potential for some non-welfare maximizing behavior, such as when a parent creates a spendthrift trust for a child.¹¹⁶ Even where a principal has greater capabilities with respect to a task than an agent, the principal may also have higher opportunity costs, and thus can capture a Pareto gain from the agent's relatively inexpensive labor.¹¹⁷

Despite these obvious advantages, agency relationships also come with significant costs. One of the central insights of economic agency cost theory over the past generation is that while an agency relationship may be relatively efficient in comparison to no relationship at all, the incentives of a principal and her agent nevertheless are frequently (if not always) misaligned.¹¹⁸ Principals virtually never enjoy representation of an agent with the same cost-to-benefit ratio for expending resources on the completion of a given productive task. For example, in the classic corporate context, the manager of a company who has no wealth invested in the corporation she manages will have relatively little incentive to carefully manage corporate funds in comparison to the shareholders of that corporation.¹¹⁹ Similarly, because a real estate agent receives only a percentage of the purchase price of a home, he has less incentive to invest time driving up the marginal sale price than the actual seller the agent represented.¹²⁰

Social norms, business practices, contract terms, and the legal system often attempt to more closely align the incentives of agents and their principals. When asked by a stranger at the beach to temporarily watch the stranger's belongings, most people will invest some care and attention for those belongings even at a cost to themselves. Likewise, shareholders expect CEOs and other corporate managers to carefully and transparently document the expenditure of corporate resources to facilitate oversight. Similarly, a real estate

116. See Sitkoff, *supra* note 20, at 674-77 (describing the governance and benefits of "spendthrift trusts"). Spendthrift trusts have an advantage over ordinary trusts because they shield the assets within the trust from the beneficiaries' creditors. *Id.*

117. A Pareto gain (or a Pareto-efficient result) occurs when resources are allocated such that at least one individual is better off, without making any other individual worse off. James Gordley, *The Moral Foundations of Private Law*, 47 AM. J. JURIS. 1, 5 (2002).

118. Jensen & Meckling, *supra* note 12, at 308. *But see* Posner, *supra* note 11, at 230 (observing that the tension between the principal's and agent's goals should not be exaggerated because they can be overcome if the agent is paid enough).

119. See Posner, *supra* note 11, at 233-34 (remarking that shareholders of a corporation have comparatively more incentive to monitor corporate funds and practices than does a corporate manager, who will often be paid with a combination of salary plus stock or stock options, thus having less invested in the corporation).

120. See *id.* at 228-29 (noting that despite the incentive that a percentage rate commission affords, expending effort might not be worth it to a real estate agent if there is only a limited chance that a house will sell).

broker contract, which provides a bonus for obtaining a large sale price, might mitigate some of the agent's incentive to shirk his duties.¹²¹ And, the law holds a trustee liable to his beneficiaries for losses sustained from reckless or unauthorized investments.¹²² Indeed, so entrenched is the notion of the need to keep the incentives of agents and principals aligned that the law frequently holds principals liable for the misdeeds of an agent.¹²³

For a person or business to decide whether or not to contract with an agent, she must weigh the expected benefits of that relationship against its potential costs. Economic agency cost theory can assist in analyzing and quantifying those costs. Perhaps the most influential model of agency costs, first established by Jensen and Meckling, defines "agency costs as the sum of three variables: (1) the monitoring expenditures of the principle, (2) the bonding expenditures by the agent, and (3) the residual loss."¹²⁴

The first type of agency cost is expenditures by the principal in monitoring the agent. By monitoring costs, economists usually imply not only observing the behavior of the agent, but also "efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules, etc."¹²⁵ Sometimes commentators divide this class of agency cost into external and internal monitoring.¹²⁶ With respect to the former, investors in a firm might hire accountants to periodically audit the books of a venture to deter inefficient allocation of resources by managers. Or with respect to the latter, a homeowner might purchase a newspaper and read the classified listings to discover whether her realtor is advertising the home as promised.

The second class of agency costs are usually labeled "bonding expenditures." By this, economists refer to situations where the principal will pay the agent to expend resources to guarantee that the agent will not take actions that harm the principal.¹²⁷ A bonding cost is incurred where the principal pays a premium to the agent to create some pool of resources or a legal obligation from which the principal

121. See *id.* at 226-29 (exploring the agency incentives of contracts where compensation increases with performance).

122. See Sitkoff, *supra* note 20, at 641-42, 655-57 (discussing the duty of care that a trustee owes to the beneficiaries of the trust).

123. Thus, the doctrine of respondeat superior. See generally W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 69, at 499-501 (5th ed. 1984) (discussing the theory and evolution of vicarious liability in tort law).

124. Jensen & Meckling, *supra* note 12, at 308.

125. *Id.* at 308 n.9.

126. E.g., Meurer, *supra* note 13, at 735-36.

127. Jensen & Meckling, *supra* note 12, at 308.

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can be compensated for detrimental actions of the agent. Thus, for example, where a legal client hires an attorney for representation, a portion of the client's legal fees is diverted by the attorney into malpractice insurance premiums. If the attorney takes actions inconsistent with the interests of her principal that amount to malpractice, the principal will have a relatively certain pool of funds available for compensation.

Bonding can serve as a substitute for monitoring costs, and vice versa. A certain bonding expenditure may decrease the marginal expected utility of monitoring expenditures. Moreover, inability to bond might signal a need to invest additional resources in monitoring. For example, a testator might reject an estate planning attorney who is uninsurable since the bonding expenditure associated with the malpractice premium is a particularly worthwhile investment in protecting against potentially catastrophic losses associated with negligent estate planning. But, perhaps more importantly, the uninsurability of the attorney signals a troubling message from insurance companies, which are parties that specialize in monitoring and spreading this type of risk. The goal of the law in this respect should be to create incentives that encourage an optimal mix of bonding and monitoring costs.¹²⁸

The final class of agency costs is the principal's lost welfare caused by the divergence in her interests from those of her agent.¹²⁹ If because of circumstances such as technology, geography, or even personalities involved, an agent cannot be perfectly monitored or bonded, then we should expect that the interests of the principal and the agent will not be coextensive. This remaining pocket of diverging interests is generally called the "residual loss" associated with agency.¹³⁰ A client might monitor her attorney by calling regularly to ask about the status of a case. The parties might make bonding expenditures by taking a portion of hers and other clients' fees and allocating them for malpractice insurance. But, she can only call so often before the attorney will no longer pay attention to her demands—creating a diminishing marginal return from time invested in this form of monitoring. And, malpractice insurance policies cannot be continually renegotiated to cover every possible outcome harmful to the client. The malpractice insurance might

128. Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1093-94, 1149-50 (1981) (exploring legal incentives on bonding and monitoring of in termination of relational contracts).

129. Jensen & Meckling, *supra* note 12, at 308.

130. *Id.*

cover catastrophic negligence, but it will not compensate the client for an attorney whose mind wanders while preparing a brief, leading to less than hoped for actual legal work product per billed hour. Despite the client's best monitoring and bonding expenditures, the attorney who enjoys daydreaming whilst on the clock retains her incentive to work more slowly. The client cannot easily discover the less than fully effective service allowing the attorney to capture a windfall when compared to the parties' contract. This windfall—the residual loss—is an agency cost the client must consider in comparing the benefit of an agent to its opportunity cost.

It is at least theoretically possible that a principal could create a fee structure to proportionally compensate the agent for the value of each action taken. But, to achieve this fee-to-act compensation structure, the value of each action taken by the agent would need to be “completely known” to the principal.¹³¹ In the real world, obtaining this information and negotiating the contractual terms of this contract is highly unlikely—particularly given that at some point marginal investment in monitoring will be offset by decreases in the agent's productivity. Thus, the distraction from a client calling her attorney once an hour to make sure she is on task might take up more of the attorney's time than the daydreaming about which the client is concerned. Rational principals will expend effort on monitoring and bonding until their marginal price of doing so is less than the expected benefit. High monitoring and bonding costs may explain why so many agency relationships lack fee-to-act payment structures. A six percent commission has been nearly universal for real estate agents.¹³² And, legal clients rarely give their counsel bonuses for highly productive billable hours. In the real world, residual loss is often the dominant agency cost.

In policing agency relationships, the legal system is not only concerned about aligning the incentives of principals and agents. Perhaps even more prominent are the policies addressing third parties affected by a principal's agent. It is true that agency law affords damages to a principal from an agent who by illegally shirking his duties has harmed the principal. Yet, an old and oft-disputed stew-pot of litigation focuses on the extent to which principals can be

131. Ross, *supra* note 11, at 138.

132. Posner, *supra* note 11, at 229; see Christopher Curran & Joel Schrag, *Does it Matter Whom an Agent Serves? Recent Changes in Real Estate Agency Law*, 43 J.L. & ECON. 265, 271 (2000) (observing that in 1993 the mean commission for houses sold was slightly over six percent).

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held liable for the behavior of their agents that is harmful to others.¹³³ This harmful behavior may be unintentional—a result of accidental behavior just as likely to occur had the principal acted without an agent. But, the harmful behavior might also have a causal link to the agency relationship itself. Sometimes agency relationships *facilitate* harmful and inefficient behavior.

Returning to our example of a client and her lawyer, suppose that the client for nefarious purposes hopes to intentionally inflict some harm on a third party. She might physically assault her victim, but doing so would invite punishment from the state. She might say hateful things to the victim, but unlike sticks and stones, words may not achieve the desired result. An attorney, however, might be capable of using words in a special way to enlist the state in harming the victim. Thus, the client might turn to an agent—a seasoned and cynical litigator with experience in using the machinery of law to impose costs on others—to maliciously sue her victim for no good reason. Rational, self-interested parties to the agency relationship could both benefit: the client gets satisfaction and the attorney gets paid.¹³⁴ The law however, considers the interests of the third party and will impose a penalty on both the lawyer and the client for misusing its process.¹³⁵ For us, the important point is that agency relationships—when left unchecked—can be used to capture an agent's comparative advantage in both socially beneficial *and* socially destructive behavior. With the behavior of agents, as with all human behavior, the law must create a regime of rules and procedure to sort out acceptable from unacceptable acts. Agency cost theory does not alter this imperative. We should expect Pareto dominated outcomes and great injustice, where agents specialize in illegitimate, yet profitable, acts that principals cannot themselves perform—or at least cannot perform without getting caught.

133. See, e.g., *Gleason v. Seaboard Air Line Ry. Co.*, 278 U.S. 349, 356-57 (1929) (holding a principal liable for an agent's tortious acts committed within the course and scope of the agent's employment).

134. It is not much of an objection to say that the client's preference to harm another is irrational. Economics has traditionally had little to say about the tastes of economic actors. PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 81 (16th ed. 1998). Economic theory in general, and agency theory in particular, does not have insight into *why* individuals and firms prefer the things they do. Rather economic analysis helps us understand what individuals and firms will be willing to pay to realize their preferences given the forces of supply and demand. *Id.* In this view the client would not be irrational for wanting to inflict harm on another. Rather she would be irrational for paying more to inflict it than she had to.

135. See, e.g., FED. R. CIV. P. 11 (authorizing the court to impose sanctions for presenting a pleading when it is for an improper purpose, when it is not warranted by existing law, when the pleading is not supported by evidence, or when denials of factual contentions are not warranted on the evidence).

III. BANK AGENTS AND PREEMPTION IN AN ERA OF PREDATORY
LENDING: AGENCY COSTS AND THE INCENTIVE TO FOREGO PREDATORY
BEHAVIOR

Although an agent and its principal both expect that their respective utility will exceed their costs, they do not necessarily share the same incentive structure vis-à-vis the third parties and the government. Thus, in the case of consumer lending, it could be that a depository institution itself will have a greater incentive to avoid predatory behavior than will an agent of that institution. In this Part, I argue that both consumer financial services law and the capital structure of that industry suggest at least three compelling reasons why bank agents are likely to be less averse to predatory lending than the banks they represent.

First, agents of depository institutions are likely to be relatively less concerned about damage to their reputation from allegations of predatory lending. Unlike their agents, banks have significant sunk costs invested in public perception of their business. Much of a bank's customer base is the result of its image and brand identity in its target market.¹³⁶ To this end, banks spend significant resources in advertising and community relations. Banks tend to have high profile roles in their communities. On this point, Landes and Posner persuasively explained that consumers purchase something of significant value when contracting with brand name firms.¹³⁷ The argument is that consumers recognize that higher profile firms have unrecoverable sunk costs, and thus are willing to pay a premium for the greater assurances associated with a brand name.¹³⁸ When purchasing complex financial services where the consumer does not understand the terms of an agreement, there is no substitute for trust. Even in an era of deposit insurance, it also takes significant trust to leave one's money with a bank. Indeed this is why banking regulators uniformly consider reputational threats to be an important component of safety and soundness, even where that threat may not pose a short term threat to deposit insurance funds. After all, when a car dealership is accused of cheating consumers, people may or may not be surprised; but when a national bank is accused of cheating, it

136. It is generally well settled that the willingness of a firm to engage in a particular type of behavior can vary significantly with the extent that behavior is observable. See, e.g., Steven C. Hackett, *Is Relational Exchange Possible in the Absence of Reputations and Repeated Contact?*, 10 J.L. ECON. & ORG. 360 (1994) (investigating the feasibility of sharing based relational contracts where behavior is unobservable).

137. William M. Landes & Richard Posner, *Trademark Law: An Economic Perspective*, 30 J.L. & ECON. 265, 268-69 (1987).

138. *Id.*

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makes the evening news. This is not to say agents of depository institutions will be completely indifferent to reputational harm, but rather that they are unlikely to care as much as the depository institution itself. Accordingly, other things being equal, agents of depository institutions will be marginally more averse to the reputational risks associated with predatory lending.

Second, agents of depository institutions are likely to have less assets exposed to liability than depository institutions themselves. The primary deterrent to predatory lending in the American legal system is the risk of compensating victims for damages they have sustained. Indeed the threat of damages is the primary tool used to enforce most law in our system. This is why the growing trend of judgment proof commercial enterprises, particularly higher risk enterprises, is such a troubling development. Lynn Lopucki has exposed a variety of strategies firms use to avoid compensating judgment creditors.¹³⁹ The shared theme of each of these strategies is separating the liability generating component of a business from the assets used to fund, and those obtained from, the activity. Several commentators have pointed out that many predatory lenders depend on sheltering their assets from victims to remain viable.¹⁴⁰ This, at least in part, helps explain the extraordinary number of bankruptcies amongst subprime home mortgage lending firms in the 1990s.¹⁴¹

139. See Lynn M. Lopucki, *The Death of Liability*, 106 YALE L.J. 1, 14-38 (1996) (describing secured debt strategies, ownership strategies, exemption strategies, and foreign haven strategies as methods that firms use to avoid compensating creditors).

140. See, e.g., Vern Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit*, 52 TEX. L. REV. 1, 2 (1973) (observing sellers could avoid consumer liability by assigning contracts to a bank or finance company); Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 640 (2002) (arguing that the holder in due course is no longer necessary in residential loans); Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do With It?*, 15 HOUSING POL'Y DEBATE 715, 715-16 (2004), available at http://www.fanniemae.foundation.com/programs/hpd/pdf/hpd_1503_Engel.pdf (advocating punitive damage assignee liability for predatory loan origination in the absence of federally mandated due diligence); Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 OR. L. REV. 1095, 1137-38 (1996) (advocating ban of promissory notes and power of sale foreclosure in home improvement loans to create lender incentives to police "fly-by-night" home improvement contractors); Cassandra Jones Havard, *To Lend or Not to Lend: What the CRA Ought to Say About Sub-Prime and Predatory Lending*, 7 FLA. COASTAL L. REV. 1, 16-18 (2005) (explaining that a holder in due course doctrine used to launder predatory lending claims and form securitized mortgages); Siddhartha Venkatesan, Note, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGIS. & PUB. POL'Y 177, 177 (2003) (advocating an affirmative cause of action against predatory loan assignees).

141. Engel & McCoy, *supra* note 140, at 603; Eric Berquist, *Preparing for a Bad-Loan Boom*, AM. BANKER, Oct. 6, 2000, at 1.

However, at least one major participant in the economy has not yet been able to judgment proof its operations—at least when undertaken within its own firm structure: the depository institution. Unlike other firms and individuals, depository institutions face stiff public capital requirements associated with protecting deposit insurance funds. Banks must be cautious when engaging in predatory behavior because if a victim succeeds in obtaining damages, unlike an increasing number of businesses, the bank must actually pay. In contrast, agents of banks may be much more likely to declare bankruptcy in the face of significant predatory lending liability. And, if the profits of that predatory lending have already been distributed to shareholders, management, and secured creditors, predatory lending victims will have no remedy.¹⁴² Moreover, unlike banks that face significant entry and exit costs, independent contractors such as mortgage brokerages, car dealerships, and loan servicing companies face virtually no entry or exit costs, since they require only minimal overhead, equipment, and financial reserves. It is far easier for these businesses to simply slip out of existence once the heat for predatory practices is turned up. Unlike depository institutions, independent contractor agents of depository institutions have a relatively greater incentive to evolve into predatory specialists with a low-asset, judgment proof, fly-by-night capital structure.

Finally, despite the best intentions of banking regulators, it is inevitable that independent contractor agents of depository institutions will receive less scrutiny than depository institutions themselves. This is because, unlike consumer agency administrators, attorneys general, and the plaintiffs' bar, the primary mission of banking regulators is to preserve the safety and soundness of the depository institutions they oversee. In a world of scarce resources, banking regulators will always be forced to make difficult choices about where and how they spend their supervisory efforts. Independent contractors of depository institutions will always rank low in priority with respect to threats posed to deposit insurance funds. Moreover, many independent contractors may be more difficult to supervise than depository institutions. For example, car dealerships which are often located in out-of-the-way places, may lack

142. It should go without saying that the bankruptcy code's ninety day preference period is small consolation to consumers on this point. 11 U.S.C. § 547(b)(4)(a) (2000). This window which allows bankruptcy trustees to avoid payments and security interests granted on the eve of bankruptcy. But, ninety days is far too short a period of time to prevent judgment proofing when compared to the extremely long life cycles of a significant predatory lending class action or attorney general lawsuit.

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the technology and record keeping to facilitate quick auditing, and—at least in some parts of the country—may have business cultures resistant to oversight by the U.S. Treasury Department. Moreover, because independent agents of depository institutions receive neither a charter nor permission to expand from banking regulators, regulators may be surprised to find how little leverage they have over these non-bank actors. All together, we should expect that these factors will systematically impede the ability of banking regulators to keep a close eye on independent contractors. Other things being equal, federal regulators' relative deterrence against predatory behavior will be marginally less for independent contractor agents than the depository institutions those agents serve.

The implications of agents' lower incentive to avoid predation are further illuminated when one considers the possibility of vicarious liability. If we assume that a bank or thrift cannot be held liable for the illegal predatory behavior of its agent, then a rational, profit-maximizing bank would simply outsource predatory behavior whenever that behavior is profitable. For consumers this is clearly the worse alternative of the two possible rules.¹⁴³

But even if the depository institution will be held liable for its agent's predation, the residual loss cost of agency suggests that the agent will still retain a predatory incentive. Take, as an example, an agency relationship between a car dealership and a national bank similar to that involved in the OCC's determination to preempt state law with respect to agents of national banks. Since the bank will be liable for its agent's practices, we can expect it to use monitoring and bonding expenditures to reduce the risk that the agent will seek to maximize its profit through illegal behavior. Liability should be a robust deterrent for the bank since it values its reputation, it has high exit and entry costs into the marketplace, and public asset requirements guarantee that the bank has significant resources to lose if exposed to the wrath of an indignant jury. Still, the profits to be had from using a car dealer as a marketing and delivery vehicle for its loans could be too tempting to pass up. We would expect that the bank would attempt to monitor the car dealership by regularly auditing the dealership's books, by conducting due diligence on the dealership's reputation and financial stability, and by retaining the right to make key decisions with respect to loan approval. A risk-

143. In a related forthcoming piece, I argue that this is precisely what has happened in the market for private label subprime home mortgage backed securities market. See Christopher L. Peterson, *Predatory Structured Finance: Securitization, Liability, and Home Mortgage Lending*, 28 CARDOZO L. REV. (forthcoming Mar. 2007).

averse bank might even require that the dealership maintain a modest cash collateral account in escrow to compensate the bank for any liability it incurs from the agent.

Still, the car dealership gets paid only by closing loans, giving it an incentive to close as many loans as possible—even ones where the borrower may not actually qualify for a loan, or where the borrower may not actually agree to the loan being offered. The dealer has an incentive to overestimate the credit worthiness of the borrower by padding the borrower's reported income. Similarly, the dealer has an incentive to obtain the borrower's signature by hiding or misrepresenting the true cost of the loan. Such risks are far from theoretical. Rather they make up the core of the thousands of consumer protection cases involving car dealerships, mortgage brokers, and consumers.

The incentive structure of the dealer is even further misaligned where the dealer is compensated with a yield spread premium, as it was in the National City Bank petition acted upon by the OCC. In such contracts, the bank obtains a monitoring advantage of knowing that the dealer will try to get the greatest return possible on the bank's assets. But, this return may or may not be a legal return. In a democratic society, banks and car dealers must not discriminate in the prices they charge based on impermissible protected classes. Doing otherwise is a violation of the Equal Credit Opportunity Act (as well as the Fair Housing Act in the case of home mortgages).¹⁴⁴ But even absent discrimination, yield spread premiums are an invitation to loan brokers to commit fraud and to commit deceptive practices,¹⁴⁵ as well as violate the Truth-in-Lending Act,¹⁴⁶ since consumers must somehow be enticed into agreeing to a contract with a value *lower* than the consumer's opportunity cost. By definition, rational consumers will not agree to pay higher interest rates than they qualify for from the very lender with whom they contracted. Yield spread premium compensation is contingent upon an irrational contract. Where a broker or dealer specializes in obtaining consumer signatures on contracts that are against the consumers' own best interests, we should expect fraud, deception, and obscured disclosure.

144. Fair Housing Act, 42 U.S.C. §§ 3601-3619 (2000).

145. TAMING THE SHARKS, *supra* note 22, at 142-43.

146. Truth in Lending Act, 15 U.S.C. § 1601 (2000); *see* Westbank v. Maurer, 276 Ill. App. 3d 553, 559 (1995) ("The purpose of the [Truth in Lending] Act is to promote the informed use of credit by requiring lenders to make meaningful disclosure of the debtor's rights and obligations in a form easily understood by the debtor.").

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This analysis exposes a troubling paradox in the recent public policy advocacy of depository institutions and federal banking regulators. With one hand, banks and their regulators are attempting to distance themselves from their proxies. Frequently in predatory lending cases involving a lender and an independent contractor of that institution, consumers will propose joint liability theories seeking to hold the depository institution liable for the behavior of its agent. Without variation, in these cases, the lenders characterize their agents as autonomous and independent so that the wrongful actions of the one cannot be attributed to the other.¹⁴⁷ Therefore, when a bank takes a home mortgage on assignment from a table-funded mortgage broker, it is likely to claim that it lacked notice of any fraud by the broker. Thus, the bank preserves its status as a holder in due course.¹⁴⁸ Or, when a bank makes an automobile loan to a consumer through a car dealer agent, the bank will refuse to accept responsibility for the fraud, deception, and obscured disclosure of the dealership.¹⁴⁹

Yet, on the other hand, depository institutions and federal banking regulators are attempting to characterize their proxies as virtually indistinguishable from themselves. In the debate over preemption of state law with respect to agents, banking regulators have characterized the legal boundaries between a depository institution and its non-bank agent as merely a choice about capital structure with little or no bearing on the commercial reality of the transactions in which the agent will engage.¹⁵⁰ Thus, in its opinion on preemption of state law with respect to independent contractors of thrifts, the OTS explained:

147. See, e.g., *Mason v. Fieldstone Mortgage Co.*, No. 00 C 0228, 2000 WL 1643589, at *1 (N.D. Ill. 2000) (holding that financial institutions were not defendant's agents, and so defendant was not liable for their actions under aider-abetter liability); *Matthews v. New Century Mortgage Corp.*, 185 F. Supp. 2d 874, 890 (S.D. Ohio 2002) (finding a sufficient pleading by plaintiff of civil co-conspirator liability); *George v. Capital S. Mortgage Invs., Inc.*, 961 P.2d 32, 35-39, 44-45 (Kan. 1998) (inferring joint venturer liability, from the evidence); *Williams v. Aetna Fin. Co.*, 700 N.E.2d 859, 868-69 (Ohio 1998) (allowing liability under a theory of civil co-conspirator liability); *Pennsylvania v. Parisi*, 873 A.2d 3, 10-11 (Pa. Commw. Ct. 2005) (rejecting defendants' denial of aider-abetter liability).

148. See Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1301 (2001) ("[A] secondary-market purchaser can defeat 'personal' defenses if it meets the following requirements for a holder in due course: (1) the purchaser is the holder, (2) of a negotiable note, (3) who took the note for value, (4) in good faith, and (5) without notice of the defenses.").

149. *Jackson v. S. Holland Dodge, Inc.*, 726 N.E.2d 1146, 1146 (Ill. App. Ct. 2000).

150. OTS, P-2004-7, *supra* note 67, at 24-25.

[F]ederal savings associations have the freedom to make business decisions about the manner in which they will conduct their operations. This includes decisions as to how to market and offer the association's products and services, and how to best facilitate customer access to, and applications for, such products and services. An association's decision as to how to conduct its operations and market its products and services should not result in the association being subject to a hodgepodge of state requirements. An association should not be hamstrung in the exercise of its authorized powers merely because it chooses to market its products and services using agents whose activities the association closely monitors and controls.¹⁵¹

The use of the word "merely" is rather befuddling, given that the agency had just used the federal thrift statutes to preempt state law for people that are *not* thrifts. More importantly, the profoundly different predatory incentives of a thrift, in comparison to its independent contractor, hint at a concrete economic reason why preemption should not extend beyond the federally chartered depository institution itself.

Certainly the extent to which a depository institution will have notice of and control over the predatory behavior of an independent agent will depend on the facts of each circumstance. But then, is this not an argument against preempting state law with respect to independent agents? State governments have the ability to experiment with different approaches in designing rules to ferret out which types of contracts and which types of agents are more likely to engage in predatory behavior than their depository masters.¹⁵² State governments have the geographic flexibility to more accurately respond to the wide variations in the severity of credit fraud in different states. State governments are more likely to have a vested local political interest in responding to the needs of consumers affected by predatory lending. State governments are more likely to have an infrastructure in place that is capable of dealing with car dealers, mortgage brokers, loan services, and other agents than federal banking regulators, which have limited legislative missions,

151. *Id.* at 25-26.

152. See Azmy, *supra* note 26, at 391-92 (observing that federalism promotes a decentralized decision-making structure, which allows state governments opportunities for innovation and experimentation with social and economic policies). Azmy further notes that predatory lending regulations, in particular, should not be implemented at a national level until they are tested on a smaller scale by "laboratory" states. *Id.* at 393-94.

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limited funding, and limited personnel. Returning to the OCC's agent preemption determination, are the two small OCC offices in Detroit and Iron Mountain really prepared to police the consumer credit practices of Michigan's 1,930 licensed motor vehicle installment sellers¹⁵³—including those with confidence inducing names like “The Used Car Factory,”¹⁵⁴ “ACE Used Cars of Muskegon,”¹⁵⁵ and “Ultimate Value Auto Sales?”¹⁵⁶

CONCLUSION

By attempting to extend preemption to the agents of depository institutions, banking regulators have removed from state regulation complex, unpredictable, and potentially harmful relationships. The shifting incentives of agents have confounded scholars, regulators, and judges—not to mention economists—in a tremendous cross-section of legal relationships. Even with the most carefully devised monitoring and bonding expenditures, independent agents cannot be expected to always act in the interests of the depository institutions they represent. It is less likely that an independent agent's interests, even when constrained by monitoring and bonding, will happen to coincide with the welfare of the American people.

At a minimum, the agency costs associated with depository institution agents suggest that if we as a country go forward with preemption for these actors, it is absolutely essential that the fabric of state, legal, and administrative protections be replicated on a federal level. Currently, there is no credible federal legal or regulatory strategy that can deter the agents of federal depository institutions, at least with respect to the problems posed by predatory lending. There

153. The Michigan Financial Institutions Bureau license data base lists 1,930 licensed motor vehicle installment sellers in Michigan. Michigan Dep't of Labor and Econ. Growth, OFIS Search Criteria for Consumer Finance Licensees, http://www.dleg.state.mi.us/fis/ind_srch/cons_fin/ofis_consumer_finance_criteria.asp?industry=InS (last visited Oct. 25, 2006). The OCC is divided into four districts. Office of the Comptroller of the Currency, About the OCC, <http://www.occ.treas.gov/district.htm> (last visited Oct. 25, 2006). Michigan is in the central region which is headquartered in Chicago. *Id.* The Chicago headquarters regulates Indiana, eastern and northwestern Iowa, northern Kentucky, Michigan, Minnesota, eastern Missouri, North Dakota, Ohio, South Dakota, southwestern Virginia, southwestern West Virginia, and Wisconsin. *Id.*

154. Michigan Motor Vehicle Installment Seller License No. IS-19592, http://www.dleg.state.mi.us/fis/ind_srch/cons_fin/consumer_finance_companies_detail.asp?nbr=19592&type=IS (last visited Oct. 25, 2006).

155. Michigan Motor Vehicle Installment Seller License No. IS-0010722, http://www.dleg.state.mi.us/fis/ind_srch/cons_fin/consumer_finance_companies_detail.asp?nbr=0010722&type=IS (last visited Oct. 25, 2006).

156. Michigan Motor Vehicle Installment Seller License No. IS-20644, http://www.dleg.state.mi.us/fis/ind_srch/cons_fin/consumer_finance_companies_detail.asp?nbr=20644&type=IS (last visited Oct. 25, 2006).

is no federal usury law to check the outrageous prices of payday loan banking agents.¹⁵⁷ There is no serious federal predatory mortgage lending law.¹⁵⁸ There is no private cause of action for the Federal Trade Commission Act to enforce the FTC's regulations on unfair and deceptive trade practices.¹⁵⁹ For their part, federal banking regulators have not flinched, even as credit card interest rates have crept closer and closer to the federal per se extortionate loan sharking trigger of the Consumer Credit Protection Act.¹⁶⁰ Even well-settled and long established federal consumer protection statutes, such as the Truth-in-Lending Act, are in a state of shameful disrepair.¹⁶¹ And finally, there are simply far too few federal regulators to monitor the agents of depository institutions.

Furthermore, policy makers must accept the reality that if the legal system grants agents of federal depository institutions immunity from state laws, it will create a potentially irresistible incentive for states to follow suit. If federal depository institutions can outsource their special legal status along with their operations, then state depository institutions, and the regulators that derive their revenue and power from them, will inevitably clamor for the same treatment. The floor must not be lowered for agents of federal depository institutions, lest the floor be lowered for agents of all depository institutions.

157. See National Consumer Law Center, Comments on Community Reinvestment Act Regulations (Apr. 6, 2003), http://www.consumerlaw.org/initiatives/test_and_comm/040604MS.shtml (recommending that the Federal Reserve Board exercise its authority to visit the "question of the legality, fairness, and morality of payday lending" practices).

158. See Peterson, *Federalism and Predatory Lending*, *supra* note 4, at 59 (discussing the narrow scope and substantive limitations of HOEPA).

159. Section 45(m) of the Federal Trade Commission Act provides only for governmental commencement of civil actions to enforce the Act in prevention of unfair or deceptive acts and practices. Federal Trade Commission Act, 15 U.S.C. §§ 41-58 (2000).

160. See 18 U.S.C. § 892(b) (2000) (establishing presumption of extortion for loans with interest rates in excess of forty-five percent); Kathleen Day & Caroline E. Mayer, *Credit Card Penalties, Fees Bury Debtors; Senate Nears Action on Bankruptcy Curbs*, WASH. POST, Mar. 6, 2005, at A1 (reporting that some credit card penalty interest rates are as high as forty percent).

161. The Truth-in-Lending Act's \$25,000 scope limitation is now lower than the purchase price of a middle class family sedan. 15 U.S.C. § 1603(3). Inflation since the Congress adopted the Truth-in-Lending Act has rendered the statutory damage awards for violations of the Act comically irrelevant. The maximum statutory damage award for an ordinary Truth-in-Lending violation is \$1,000, which is now the equivalent of approximately \$193.00 in 1968 dollars. Robert C. Sahr, Consumer Price Index ("CPI") Conversion Factors to Convert to 2005 Dollars, http://oregonstate.edu/Dept/pol_sci/fac/sahr/cv2005_x.pdf (last visited Oct. 25, 2006). Moreover, by the Federal Reserve Board's own admission, only seventy-eight percent of national banks actually complied with the Truth-in-Lending Act in 2003. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, 91ST ANNUAL REPORT 71 (2004), <http://www.federalreserve.gov/boarddocs/rptcongress/annual04/ar04.pdf>.

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The regulatory apparatus of the United States has not yet demonstrated the capability to successfully regulate the abusive and predatory practices of depository institutions themselves. It is nonsensical to suggest, with hardly a quiet breath of authorization from the Congress, that federal banking regulators can be trusted to also police actors lending through tenuous, shifting, and volatile agency relationships. Indeed, it leads one to fear that federal regulators have only token intentions to police these relationships at all. And therein lies a final ironic twist: perhaps the more fundamental principal-agent monitoring failure lies in the inability of the American people to successfully monitor their agents charged with overseeing the nation's banking industry.